



April 3, 2015

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Re: Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies (GSIBs) (RIN 7100 AD-26), (Regulation Q; Docket No. R-1505)

Sir or Madam:

Better Markets, Inc.¹ appreciates the opportunity to comment on the above-captioned proposed rule (“Proposed Rule”) of Board of Governors of the Federal Reserve (“Board”).

INTRODUCTION AND SUMMARY OF COMMENTS

On December 9, 2015, the Board issued a Notice of Proposed Rulemaking to establish risk-based capital surcharges for systemically important U.S. bank holding companies. The Proposed Rule asks 33 questions in the area of GSIB identification, application, and utilization of systemic indicators; computation of GSIB surcharges and their implementation; augmentation of the capital conservation buffer; the process for review and refinement of the proposal; and use of short-term wholesale funding by GSIBs.

In this comment letter, we:

- support the Board’s proposed GSIB surcharges “to reduce a GSIB’s probability of default such that a GSIB’s expected systemic impact is approximately equal to that of a large, non-systemic bank holding company;”²
- offer considerations regarding the size and concentration of banks to reaffirm the Board proposal for GSIB surcharges;

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

² Proposed Rule, page 9.

- encourage the Board to include the proposed GSIB surcharge in the GSIB's capital plans and stress tests;
- support the Board's proposal to incorporate a measure of short-term wholesale funding use into the capital framework to address the risks presented by those funding sources; and
- encourage the Board to expand its short-term wholesale funding data collection efforts.

BACKGROUND

On December 9, 2014, the Board issued a Notice of Proposed Rulemaking to establish risk-based capital surcharges for systemically important U.S. bank holding companies. It would "require a U.S. top-tier bank holding company with \$50 billion or more in total consolidated assets to calculate a measure of its systemic importance and would identify a subset of those companies as global systemically important bank holding companies based on that measure. A global systemically important bank holding company would be subject to a risk-based capital surcharge that would increase its capital conservation buffer under the Board's regulatory capital rule."³

The Board is undertaking this rulemaking pursuant to Section 165 of the Dodd-Frank Act, which states in part:

"In order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions, the Board of Governors shall, on its own or pursuant to recommendations by the Council under section 115, establish prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies with total consolidated assets equal to or greater than \$50,000,000,000 that— (A) are more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States; and (B) increase in stringency, based on the considerations identified in subsection (b)(3)."⁴

Moreover, Section 165 (b)(1)(B) authorizes the Board to establish additional prudential standards for GSIBs:

"The Board of Governors may establish additional prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies described in subsection (a), that include—

³ Proposed Rule, page 1.

- (i) a contingent capital requirement;
- (ii) enhanced public disclosures;
- (iii) short-term debt limits; and
- (iv) such other prudential standards as the Board of Governors, on its own or pursuant to a recommendation made by the Council in accordance with section 115, determines are appropriate.”⁵

In the proposing release, the Board emphasizes that despite extensive undertakings to reform and strengthen the financial system through the comprehensive reform of financial regulation, “a perception persists in the markets that some companies remain too big to fail, which poses a significant threat to the financial system.”⁶ The Board explains that “this perception [of too big to fail] is unfair to smaller companies, damages fair competition, and may artificially encourage further consolidation and concentration in the financial system.”⁷

To counter this perception, the Board proposes GSIB surcharges, which are designed to “reduce a GSIB’s probability of default such that a GSIB’s expected systemic impact is approximately equal to that of a large, non-systemic bank holding company. Distress at a GSIB would have substantially greater negative consequence on the financial system than the failure of other bank holding companies that may be large or interconnected, but that do not have comparable systemic profiles.”⁸

COMMENTS

GSIB surcharges are important “to reduce a GSIB’s probability of default such that a GSIB’s expected systemic impact is approximately equal to that of a large, non-systemic bank holding company.” As important elements of the enhanced prudential standards, they should be implemented as soon as possible.

The risk of contagion in the financial markets that could arise from the failure of a GSIB has been a long-standing concern among economists and policymakers, and the introduction of capital surcharges for the largest financial institutions is a sound tool for addressing this concern. For example, Mike Konczal of the Roosevelt Institute conducted an analysis of such surcharges and concluded that:

“A strong implementation of a SIFI surcharge is important for four different reasons. The first is that it internalizes risks a firm poses to the financial system as a whole to the individual firms themselves. To the extent that the largest, most risky, firms pose risk to the system as a whole, they should be required to fund themselves with more equity and maintain a stronger balance sheet. A related second reason is that it would combat the widespread notion

⁵ Dodd Frank Act, Section 165.

⁶ Proposed Rule, page 5.

⁷ *Id.*

⁸ *Id.* at page 9.

that the largest banks receive a backstop from the federal government. . . . A third reason is that it would help control the size and scale of our largest financial institutions. . . . A fourth reason is that it would make the OLA [Orderly Liquidation Authority] more practical and much more likely to work. The chief FDIC regulator has stated that size alone can make a successful OLA procedure more difficult to pull off.”⁹

IMF staff have expressed concerns about GSIB’s complexity and contagion risk, stating that:

“[S]IFIs also have the capacity to spread distress to the broader financial system and economy, given the scale of their activities, the essential functions they provide, and their interlinkages with other financial institutions and markets. The complexity and integrated nature of group structures and operations, with multiple legal entities spanning national borders and business lines, make it very difficult not only to manage and supervise SIFIs but also for orderly resolution in the event of their failure.”¹⁰

Unfortunately, the concentration of business within TBTF institutions has only increased since the beginning of the global financial crisis. For example, in 2011, the IMF wrote about the enduring problem of systemic risk posed by the large banks:

“Many of the structural characteristics that contributed to the buildup of systemic risk in financial sectors are still in place today, and moral hazard has increased. In most countries, the structure of the financial system has changed little. In fact, as large banks acquired failing institutions, concentration has increased on average – for the 12 recent crisis countries, the assets of the five largest banks have risen from 307 percent of GDP before crisis to 355 percent in 2009-complicating resolution efforts. The large-scale public support provided to institutions and markets – a contingent liability equivalent to one-fourth of GDP at the peak of the crisis – has exacerbated perceptions of “too important to fail” (Goldstein and Veron, 2011). Failing firms may be resolved in a number of ways, but in the recent crisis, few creditors were forced to write down claims because of the risk of contagion. The shielding of creditors restored confidence more quickly, but it did so at the cost of moral hazard and the perpetuation of too-important-to fail problem (and stretched sovereign balance sheets).”¹¹

Similarly, in 2014, the Vice Chairman of the U.S. Federal Deposit Insurance, Thomas M. Hoenig, detailed the problem regarding U.S.-based global institutions:

⁹ Mike Konczal, *Capital Requirements: Hitting Six Birds With One Stone* (November 2013).

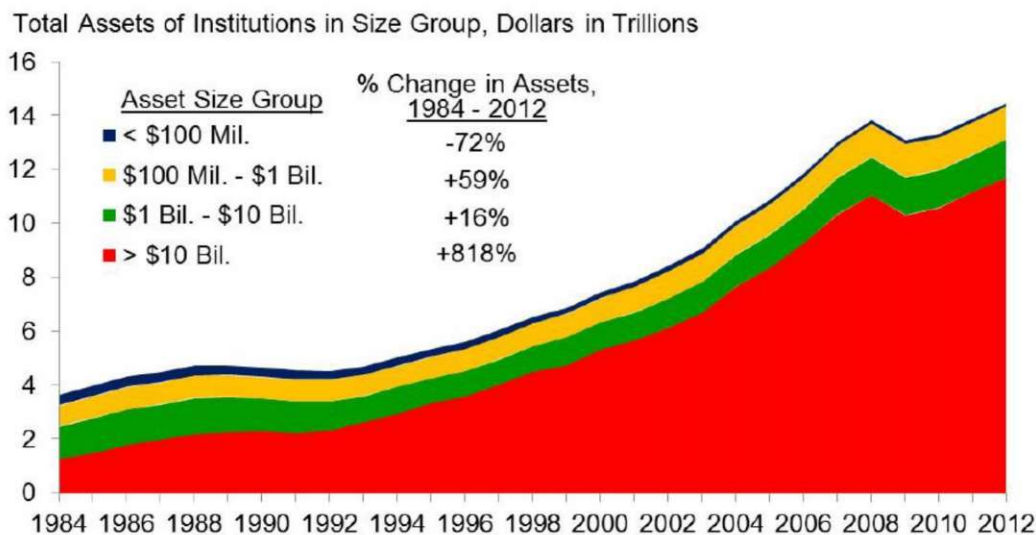
¹⁰ IMF staff discussion note, *The too-important-to-fail conundrum: impossible to ignore and difficult to resolve* (May 27, 2011), page 5.

¹¹ International Monetary Fund, *Crisis Management and Resolution: Early Lessons from the Financial Crisis* (Mar. 9, 2011).

“The chart titled Consolidation of the Credit Channel [below] shows the trend in concentration of financial assets since 1984. The graph shows the distribution of assets for four groups of banks, ranging in size from less than \$100 million to more than \$10 billion. The chart shows that in 1984, the control of assets among the different bank groups was almost proportional. Also, within each group if a single bank failed, or even the largest, it might shock the economy, but most likely would not bring it down. Today this distribution of assets is dramatically different. Banks controlling assets of more than \$10 billion have come to compose an overwhelming proportion of the economy, and those with more than a trillion dollars in assets have come to dominate this group. If even one of the largest five banks were to fail, it would devastate markets and the economy.”¹²

Consolidation of the Credit Channel

Change in Assets by Bank Size Groups (1984-2012)



Source: FDIC. Reflects the aggregation of total assets of FDIC-insured institutions by bank holding company and also includes charter-level assets for banks with no holding company.

Professor Stephen Cecchetti of the Brandeis International Business School sums up the balance between financial stability/public well-being and an enhanced regulatory regime for the systemically important financial institutions by saying that:

“[I]n the end, one needs to balance the social costs of imposing higher capital requirements against the social benefits of preventing or mitigating a future

¹² Thomas Hoenig, *Speech to the National Association for Business Economics 30th Annual Economic Policy Conference*, (Feb. 24, 2014).

costly financial crisis Regulators should continue to ratchet up bank capital requirements until the tradeoff between banking efficiency and financial safety shifts appreciably in favor of the latter. Importantly, as capital levels rise, we will become more certain of the cost in terms of increased lending spreads, reduced loan volumes, and shifts of activity to less-regulated intermediaries.”¹³

Finally, even representatives of the banking industry support strong capital requirements for banks. As the Government Accountability Office reports:

“Many investment firm representatives credit enhanced regulatory standards for the largest bank holding companies with improving the safety and soundness of these firms and reducing the likelihood that they would experience distress that could result in failure or government support. One representative from a large investment firm said that the best defense against banks needing government support is to make sure they are well-capitalized.”¹⁴

Introduction of GSIB surcharges is a straight-forward approach and a sound tool for addressing the concerns associated with the increasing concentration of the systemically important financial institutions and the potentially overwhelming consequences of their failure for the American economy.

In addition, the Board should go one step further and ensure that the proposed GSIB surcharges are included in GSIB capital plans and stress tests. Specifically, the Board should add GSIB surcharges to post-stress capital ratios under the severely adverse scenario of the Board’s Comprehensive Capital Analysis and Review.¹⁵ Doing so would ensure the comprehensive and meaningful inclusion of the GSIB surcharges in the U.S. capital framework, and would allow a dynamic regulatory reaction to new risk stemming from changes in financial markets and business models of the financial institutions.

The Board properly incorporates a measure of short-term wholesale funding in the capital framework and should expand the Board’s short-term wholesale funding data collection efforts.

The role of short-term wholesale funding in spreading the crisis of 2008 has been well-documented and the Board’s focus on incorporating a measure of short-term wholesale funding into the capital requirements is an important step to strengthen the resilience of the U.S. financial system. Eric Rosengren, President and Chief Executive Officer of the Federal

¹³ Stephen Cecchetti, Centerl for Economic Policy Research, *The jury is in* (December 2014), page 5.

¹⁴ U.S. Government Accountability Office, *Large Bank Holding Companies, Expectations of Government Support* (July 2014), page 29.

¹⁵ For the CCAR 2015 requirements, see Board of Governors of the Federal Reserve System, *Comprehensive Capital Analysis and Review 2015 Summary Instructions and Guidance* (Oct. 2014), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20141017a1.pdf>.

Reserve Bank of Boston, analyzed the impact of short-term wholesale funding on the 2008 crisis as well as the overall stability of the financial system in his November 5, 2014 speech:

“[T]he events of 2008 present ample reason to have concerns about short-term wholesale funding. The problems caused by reduced financing extend well beyond broker-dealers. Faced with funding problems, many broker-dealers sold securities under duress at fire-sale prices – causing collateral problems for other buyers and sellers of securities.”¹⁶

Figure 2: Lehman Brothers Funding Runoff
May 30, 2008 - August 29, 2008

Funding Source	May 30 - Aug 29, 2008 (Billions of Dollars)	as a Percent of 2008:Q2 Total Assets
Repo	11.8	1.8%
Prime Brokerage	9.2	1.4%
Counterparty/Derivatives Collateral Calls	12.3	1.9%
Commercial Paper	4.2	0.7%
Other Short-Term Debt	10.1	1.6%

Source: *Lehman Brothers Holdings Inc. Chapter 11 Proceedings, Report of Anton R. Valukas, Examiner, and Exhibits, Jenner & Block LLP, Lehman Brothers Holdings Inc., 10-Q, May 31, 2008*

However, even though the weakness in short-term wholesale funding was identified as a material vulnerability to the stability of the U.S. financial system, the business models of many GSIBs still continue to rely on short-term funding. In a recent study, the Bank for International Settlements identified three bank business models and the prevalence of each among GSIBs. The business models were broken down according to the following types:¹⁷

¹⁶ Eric Rosengren, *Short-term wholesale funding risks* (November 5, 2014), page 5.

¹⁷ The authors use annual data for 222 individual banks from 34 countries, covering the period between 2005 and 2013.

1. A retail-funded commercial bank – “[I]t is characterized by a high share of loans on the balance sheet and high reliance on stable funding sources including deposits. In fact, customer deposits are about two thirds of the overall liabilities of the average bank in this group.”¹⁸ “Figure 2 [above] highlights that [the funding] problem within Lehman Brothers were troublesome well before the middle of September 2008 - based on the information from the bankruptcy examiner’s report. In the three-month period between May 30th and August 29th of 2008, there was a significant funding runoff underway from multiple sources of short-term wholesale funding – particularly involving Lehman Brother’s repurchase-agreement and derivatives counterparties.”¹⁹
2. A wholesale-funded commercial bank – “[T]he average bank in this group has an asset profile that is remarkably similar to the profile of the retail funded banks in the first group. The main differences between the two relate to funding mix. Wholesale-funded banks have a higher share of interbank liabilities and a much higher share of wholesale debt, with the balance being a lower reliance on customer deposits.”²⁰
3. A capital market-oriented bank – “[B]anks in this category hold half of their assets in the form of tradable securities and are predominantly funded in wholesale markets. In fact, the average bank in this group is most active in the interbank market, with related assets and liabilities accounting for about one fifth of the balance sheet. We label this business model ‘trading bank.’”²¹ In the Proposed Rule’s terminology, a capital market-oriented bank will have extensive reliance on the short-term wholesale funding.

The authors present a high number of “trading banks” in North America when broken down geographically and by G-SIB classification.²² The compiled data demonstrates that 12 GSIBs still have heavy reliance on short-term wholesale funding despite the vulnerabilities of this source of funding evidenced in 2008. These conclusions further support the calls of Chair Janet Yellen and Governor Daniel Tarullo to take regulatory measures to address GSIBs’ reliance on short-term wholesale banking operations. This data also supports the necessity of including a measure of short-term wholesale funding in the capital framework.

¹⁸ Roengpitay, Rungpron, Nikola Tarashev and Kostas Tsatsaronis, Bank of International Settlements, *Bank Business Models* (December 7, 2014), page 58.

¹⁹ Eric Rosengren, *Short-term wholesale funding risks* (November 5, 2014), page 4.

²⁰ Roengpitay, Rungpron, *supra* note 17.

²¹ *Id.* at page 59.

²² *Id.* at page 60.

	Retail-funded	Wholesale-funded	Trading	Total
North America	16	–	6	22
Europe	36	22	9	67
Advanced Asia-Pacific ¹	11	3	3	17
Emerging market economies	45	2	3	50
G-SIBs	14	2	12	28
Non-G-SIBs	94	25	9	128

¹ Australia and Japan.

Source: Authors' calculations.

However, more structured and coherent data collection by the Board regarding short-term wholesale funding is necessary to ensure dynamic monitoring and regulation of those activities by GSIBs and appropriate tailoring of regulatory regimes based on trends in the markets. Eric Rosengren reiterated this point by saying that:

“Disclosure has the potential to provide better information on the degree of reliance on repurchase agreements – particularly repurchase agreements involving collateral not guaranteed by the federal government – to the institutions’ stakeholders interested in the extent of its risk-taking, such as holders of its long-term debt. Because of the lack of comprehensive disclosure requirements in place at the time of the crisis, neither the significant ramp-up in the use of repurchase agreements nor the movement to repos that were backed by less secure collateral were obvious to investors. . . . Had such information been available prior to the crisis, the reliance on short-term funding based on both government and nongovernment collateral (the latter meaning collateral not guaranteed by the federal government) would have been apparent and might have resulted in greater market discipline than we saw leading up to the crisis”²³

Transparency of the short-term wholesale markets for regulators and the public is essential to monitor the emerging threats coming from those activities, and a greater effort by the Board to improve data collection and availability in this area is a critical step to strengthen financial regulation.

CONCLUSION

This comment letter supports the Board’s proposed GSIB surcharges “to reduce a GSIB’s probability of default such that a GSIB’s expected systemic impact is approximately equal to that of a large, non-systemic bank holding company.”²⁴ The comment letter highlights data reflecting of the size and concentration of banks to reaffirm the Board’s

²³ Eric Rosengren, *Short-term wholesale funding risks* (November 5, 2014), page 10.

²⁴ Proposed rule, page 9.

proposal for GSIBs' surcharges. In addition, the letter encourages the Board to include the proposed GSIB surcharge in the capital plans and stress tests.

The comment letter also supports the Board's proposal to incorporate a measure of short-term wholesale funding use in the capital framework to address the risk presented by those funding sources. Moreover, the letter encourages the Board to expand its short-term wholesale funding data collection efforts.

We hope these comments are helpful as the Agencies finalize the Proposed Rule.

Sincerely,



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